UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF INDIANA
HAMMOND DIVISION

IN RE:	)	
	)	
MICHAEL BRYCE HAUGHEE,	)	CASE NO. 05-68688 JPK
	)	Chapter 7
Debtor.	)	
**********		
MARY ANN TULLY,	)	
	)	
Plaintiff,	)	
v.	)	ADVERSARY NO. 06-6079
	)	
MICHAEL BRYCE HAUGHEE,	)	
	)	
Defendant.	)	

MEMORANDUM OF DECISION DETERMINING
DISCHARGEABILITY OF INDEBTEDNESS

This case arises from a complaint filed against the debtor, Michael Bryce Haughee ("Haughee"), in which the plaintiff, Mary Ann Tully ("Tully"), requests that a certain debt allegedly owed to her by Haughee be excepted from discharge pursuant to 11 U.S.C. § 523(a)(4) and 11 U.S.C. § 523(a)(6). The Court has jurisdiction over this adversary proceeding pursuant to 28 U.S.C. § 1334(b), 28 U.S.C. § 157(a), and N.D.Ind.L.R. 200.1(a)(2). This matter constitutes a "core" proceeding as defined by 28 U.S.C. § 157(b)(2)(I).

I. STATEMENT OF THE RECORD

This adversary proceeding was initiated by a complaint filed on March 15, 2006. Prior to the defendant filing an answer, on April 3, 2006, Tully filed her first amended complaint. In response to the court's April 30, 2007 order, on June 13, 2007, Tully filed a Verified Second Amended Adversary Complaint ("Second Amended Complaint"), which she signed and verified that the allegations were true and correct to the best of knowledge and belief. In this complaint, Tully alleged that Haughee owed her a debt which is excepted from discharge pursuant to 11 U.S.C. § 523(a)(4) and 11 U.S.C. § 523(a)(6). On July 13, 2007 the court ordered that the clerk

enter a default with respect to Haughee, and Tully then filed a motion for default judgment. However, in an order dated August 30, 2007, the court noted that the complaint was incomplete: The exhibits referenced throughout the complaint were not attached. On September 21, 2007, Tully re-filed her second amended complaint with the appropriate exhibits attached.[1]

The summons issued came back to Tully's counsel marked as "not deliverable as addressed" by the United States Postal Service. Thus, on September 26, 2007, Tully filed a motion requesting leave to attempt service upon the defendant at three alternative addresses.[2] A default judgement was finally entered against Haughee on February 28, 2008 in the amount of $8,775.75.[3]

On January 20, 2009, Haughee re-surfaced and filed a motion to vacate the default judgment and argued that he was never properly served. Apparently, in the late summer/early fall of 2006 Haughee closed the post office box which he provided as his address on the bankruptcy petition.[4] At this point Tully proceeded to conduct discovery. A hearing on the motion to vacate was held on September 17, 2009. In an order dated March 5, 2010, the motion to vacate the default judgment was granted and the court determined that Haughee was

---

[1] As a result of this deficiency, the court also vacated the Clerk's entry of default entered on July 13, 2007.

[2] The court granted this motion on September 28, 2007.

[3] As the court stated in an order dated March 5, 2010, it should not have entered the default judgment against Haughee due to the fact that although the record supported a finding that the complaint was sent to Haughee at what seemed to be a valid address – the summons was not. The return of service filed by Tully on October 1, 2007 and the "supplemental" return of service filed on November 1, 2007 only reflected service of the complaint – not the summons.

[4] The court's record in the main case corroborates this as well, docket record entry #88 in case number 05-68688 establishes that a mailing made on September 21, 2006 to that post office box was returned by the United States Postal Service with the designation "box closed/unable to forward".

never properly served with the complaint and that the court did not have jurisdiction over the defendant. The court found that the adversary proceeding remained viable and indicated that it was up to either the plaintiff or defendant to take whatever action either may deem necessary to further pursue or terminate this case. Subsequently, Tully issued an alias summons on March 18, 2010.

On May 3, 2010 Haughee filed an answer denying the substantive allegations of the Second Amended Complaint, which raised the expiration of the statute of limitations as an affirmative defense.

A bench trial was held on July 7, 2011, and the parties were ordered to file briefs concerning the statute of limitations defense raised by Haughee. The record before the Court for the purposes of rendering a final determination is comprised of the plaintiff's Second Amended Complaint, the defendant's answer, the transcript of the bench trial conducted on July 7, 2011 and the exhibits entered into evidence at trial.[5] This Memorandum and Decision constitutes the findings of fact and conclusions of law required by Fed.R.Bankr.P. 7052/ Fed.R.Civ.P. 52(a).

II. LEGAL ANALYSIS

Tully's spouse passed away on September 25, 2003. Subsequently, on October 28, 2003, Tully met with Haughee, a licensed Indiana attorney at the time, for the purpose of retaining him to possibly open a probate estate and evaluate any assets due to her.[6] On November 7, 2003, Tully entered into a fee agreement ("Fee Agreement") with Haughee which

[5] The parties stipulated at trial that all the exhibits listed on their respective witness/exhibit lists were admitted into evidence.

[6] See, plaintiff's Verified Second Amended Adversary Complaint at ¶ 6. As will be further discussed *infra*, at trial both the intended scope of Haughee's representation as well as the amount of the initial retainer Tully paid to Haughee were the subject of some debate.

set out the terms and conditions of his retention and the scope of his representation.[7]

One of Tully's husband's assets was a life insurance policy through Metropolitan Life. Tully was listed as the sole beneficiary on the policy. As Tully's attorney, Haughee obtained the proceeds of the policy in the amount of $68,865.84. He then proceeded to send Tully a billing statement for outstanding attorney fees and expenses totaling $8,775.75. But, by the time Tully received this statement, Haughee had already charged the balance due him against the $68,865.84. In the end, Tully received a check drawn on Haughee's trust account in the amount of $60,090.09. Subsequently she received a second billing invoice from Haughee in the amount of $3,590.07. Tully decided not to pay this amount, and Haughee indicated that he chose not to attempt collection, essentially writing off any fees in this statement.

Tully contends that Haughee acted outside the scope of his representation when he administered the life insurance policy and offset his outstanding legal fees against the proceeds. Secondly, she contends that Haughee's fees were unreasonable and amounted to a "gouging attempt".[8] At trial, Tully indicated that her sole focus at this point is to attempt to except from discharge the amount of $8,775.75 pursuant to § 523(a)(4) and/or § 523(a)(6). This is the amount Haughee withheld from the life insurance payout and used to offset his attorney fees.

Haughee argues that he was authorized to not only obtain the life insurance money, but also that Tully knew he was going to use a portion of it to pay his attorney fees prior to turning the remaining balance over to her. In his answer to Tully's complaint he also raised the affirmative defense that this action is barred by the statue of limitations. If true, then there would be no need for the court to rule on the merits of Tully's case. Therefore, before moving

---

[7] See, Defendant's exhibit #1.

[8] See, Trial Transcript at pg. 10, lines 7-11.

on to the ultimate question of whether there is a debt owing to Tully which is excepted from discharge, the court will first determine the validity of Haughee's affirmative defense.

A. Statute of Limitations Defense

Haughee argues that Indiana Code 34-11-2-3 bars this action from proceeding and contends that the statute began to run on January 5, 2004, which is around the time Haughee estimates that Tully terminated his representation. Tully argues that the applicable statue of limitations is found at Indiana Code 34-11-2-4 and takes the position that the statute began to run on January 20, 2004.[9] According to the statute relied upon by Haughee, any action brought in contract or tort based on professional services rendered must be filed within two years, "from the date of the act, omission, or neglect complained of." Haughee contends that the complaint "was not properly filed with service of process perfected upon the Debtor until March 31, 2010." Since this is more than six years after the dispute arose, Haughee concludes that the action is barred by the statute of limitations.

It is not altogether clear whether Haughee is arguing that: 1) the summons and complaint were not *served* timely and therefore the case should be dismissed or; 2) the complaint was not originally filed timely under state law or; 3) the case is not considered filed until the summons and complaint are properly served, and as a result this action was filed six years too late under state law. In any event, this defense fails for several reasons.

In support of his position, Haughee partly relies on this court's order of March 5, 2010, in which the court stated that as of that date it did not have personal jurisdiction over Haughee. Although the court did in fact find at that time that it did not have personal jurisdiction over Haughee, the order specifically stated that "the adversary proceeding remains viable."

[9] The court does not need to determine who is correct concerning which statue actually applies or when the time began to run. First of all, each statute provides for a two year limitation. Second, the court would reach the same conclusion as discussed *infra* even if the statute expired on January 20, 2006, as opposed to January 5, 2006.

Under Indiana law – which is the law applicable to Haughee's statute of limitations affirmative defense – an action is commenced for the purpose of tolling a statute of limitation when the complaint is filed, summons is tendered (a consideration irrelevant in this case, because summons is not tendered by a litigant in an adversary proceeding, but rather is issued by the court clerk), and the required filing fee is paid; *Ray-Hayes v. Heinamann*, Ind., 760 N.E. 2d 172 (2002). In this case, all of the required three actions for tolling occurred on March 15, 2006, and the action was commenced on that date for the purpose of tolling a statute of limitation.

Haughee confuses the requirement that an action be commenced within a certain period of time with the requirement that the complaint be served within a fixed period of time. Indiana Code 34-11-2-3 provides as follows:

> An action of any kind for damages, whether brought in contract or tort, based upon professional services rendered or which should have been rendered, may not be brought, commenced, or maintained, in any of the courts of Indiana against physicians, dentists, surgeons, hospitals, sanitariums, or others, unless the action is **filed** within two (2) years from the date of the act, omission, or neglect complained of. (Emphasis added.)

In order for this particular state statute to be satisfied it is not required that the complaint be *served* within a certain period of time as long as the complaint is *filed* within the prescribed period of time.

Perhaps Haughee is referring to the requirement in the Bankruptcy Rules that the summons and complaint be served within a certain period of time. Bankruptcy Rule 7004(e) provides that service of process is made by delivery of the summons and complaint within ten (10) days after a summons is issued and further provides that if the summons is not timely delivered or mailed, another summons is to be issued and served. Otherwise, the case could be dismissed. Bankruptcy Rule 7004(a) provides that Rule 4(m) of the Federal Rules of Civil Procedure applies in adversary proceedings. That rule provides as follows:

> Time Limit for Service. If a defendant is not served within 120 days after the complaint is filed, the court – on motion or on its own after notice to the plaintiff – must dismiss the action without prejudice against that defendant or order that service be made within a specified time. But if the plaintiff shows good cause for the failure, the court must extend the time for service for an appropriate period. This subdivision (m) does not apply to service in a foreign country under Rule 4(f) or 4(j)(1).

This rule contemplates either the filing of a motion to dismiss by the party who is seeking dismissal, or that dismissal is raised *sua sponte* by the court. However, this assertion is not the subject of an affirmative defense – it is the subject of a motion to dismiss. The court notes that under Indiana law, failure to timely serve summons does not affect tolling of a statute of limitation, but may be raised in a motion to dismiss under Trial Rule 41(E); *Geiger and Peters, Inc. V. American Fletcher National Bank & Trust Company,* Ind. App., 428 N.E.2d 1279 (1981). To the extent Haughee may seek to assert any basis for dismissal due to delay in service of process, the court has long since determined the assertion against him. As stated, any such assertion would not affect the date of commencement of this action for the purpose of tolling of a statute of limitation.

Lastly, Haughee may be contending that the original complaint was not filed timely under state law to preserve the cause of action upon which the complaint may depend to establish a debt, i.e. later than the two years provided by I.C. 34-11-2-3. Courts have in fact held that a valid statute of limitations defense is stated as to an underlying claim in a dischargeability action when the claim for a debt is barred. Under the Bankruptcy Code, a claim is defined as a right to payment and a debt is defined as a liability on a claim.[10] The theory is that if the claim is unenforceable under state law then *ipso facto* there exists no debt for a court to except from discharge; See e.g., *Kovalsky-Carr Electric Supply Co., Inc.*, 313 B.R. 555, 559-60 (Bankr. W.D.N.Y. 2004). The ramifications of this are obvious – Tully would be entitled to

[10] 11 U.S.C. § 101(4) and 11 U.S.C. § 101(11).

nothing. On the other hand, some courts believe that the statute of limitations defense is solely an affirmative and procedural defense under state law. Other courts take the position that whether a claim is enforceable or not should be left to the purview of the state court.

Tully argues that the relevant statute of limitation did not start to run until January 20, 2004 and expired two years later – January 20, 2006. The adversary complaint in this case was filed on March 15, 2006, which is clearly outside the date of January 20, 2006. Tully points out that during the period between January 20, 2004 and January 20, 2006, she filed a complaint with the Indiana Supreme Court Disciplinary Commission (July 7, 2004) and a complaint with the Lake County Bar Association Fee Arbitration Panel.[11] She posits that the filing of the disciplinary complaint tolled the statute of limitations and contends that initiating the arbitration was akin to filing a lawsuit which also tolled the statute of limitations. The cases Tully cites in support of her position discuss when and under what circumstances a tolling provision, *explicitly* set out in a statute, applies such as in the Medical Malpractice Act. See e.g., *Walker v. Memering, et al.*, 471 N.E.2d 1204,1202 (Ind. App. 1985) [*held*, "The Tort Claims Act makes no provision for tolling the statute. Such a tolling mechanism is found in the Medical Malpractice Act, 16-9.5.9.1, indicating that the legislature is aware of the utility of such a provision. The fact that a like provision does not exist in the Tort Claims Act demonstrates that the legislature did not desire it."]. These cases are inapplicable here; neither I.C. 34-11-2-3 nor I.C. 34-11-2-4 contain a tolling provision. The bottom line is that the court determines that Tully's position in this context has no validity.

But, there is more. The relevant fact is that Haughee filed his petition for relief on October 15, 2005, which is clearly *prior* to the expiration of the state statute of limitation which

[11] The fee dispute was still pending before the Lake County Bar Association Fee Arbitration Panel at the time the Debtor filed his petition for relief. It is not clear *when* this was filed, but in an exhibit attached to Tully's brief the court concludes it was sometime in the summer of 2004, most likely August.

did not expire until sometime in January of 2006. 11 U.S.C. § 108(c) provides guidance in this situation:

> c) Except as provided in section 524 of this title [11 USCS § 524], if applicable nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement fixes a period for commencing or continuing a civil action in a court other than a bankruptcy court on a **claim against the debtor**, or against an individual with respect to which such individual is protected under section 1201 or 1301 of this title [11 USCS § 1201 or 1301], and such period has not expired before the date of the filing of the petition, then such period **does not expire until the later of** –
>
> (1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; or
>
> (2) 30 days after notice of the termination or expiration of the stay under section 362, 922, 1201, or 1301 of this title [11 USCS § 362, 922, 1201 or 1301], as the case may be, with respect to such claim. (Emphasis added.)

Under 11 U.S.C. § 108(c), when a potential plaintiff receives notice that the automatic stay has been terminated, he may proceed to pursue his claim against the debtor in the appropriate forum within 30 days of receiving such notice – even if the applicable statute of limitations expired during the stay.[12] *Kimbrell v. Brown, et al.*, 651 F.3d 752, 756 (7th Cir. 2011). This concept was aptly summarized by the court in the case of, *In re Pettibone*, 110 B.R. 848, 852-53 (Bankr. N.D. Ill. 1990):

> One of the basic privileges afforded a Debtor who has filed a petition in bankruptcy is the protection of the automatic stay provision of 11 U.S.C. § 362. *Midatlantic National Bank v. New Jersey Department of Environmental Protection,* 474 U.S. 494, 503, 88 L. Ed. 2d 859, 106 S. Ct. 755 (1986). Section 362 provides that no actions may be continued or commenced against the Debtor unless the creditor attempting to bring or continue the action first obtains permission from the bankruptcy court. *Association of St. Croix Condominium Owners v. St. Croix Hotel Corp.,* 682 F.2d 446 (3rd Cir. 1982). Merely because a Plaintiff has obtained proper service and process does not settle the

[12] It goes without saying that this assumes that the underlying debt was not discharged in the bankruptcy.

> question as to whether the suit filed during the stay period is valid. While courts agree that actions already pending at the time the bankruptcy petition is filed are placed in suspension upon imposition of the stay, they are divided as to whether suits filed while a stay is in effect are void *ab initio* as in *Richard v. City of Chicago,* 80 Bankr. 451, 453 (N.D. Ill. 1987), and *In re Shamblin,* 878 F.2d 324 (9th Cir. 1989); or merely voidable upon request of the debtor, *In re Oliver,* 38 Bankr. 245, 248 (Bkrtcy. D.Minn. 1984); *Sikes v. Global Marine, Inc.,* 881 F.2d 176 (5th Cir. 1989). The Seventh Circuit has held such filing to be void in a case involving the statutory precursor to 11 U.S.C. § 362. *Matthews v. Rosene,* 739 F.2d 249, 251 (7th Cir. 1984).
>
> ***
>
> Once the stay is modified, terminates or expires pursuant to any section of the Bankruptcy Code, the state law statutes of limitations relating to actions against the debtor once again become meaningful. Whether or not limitations periods include the time the stay was in effect is dependent on the existence of specialized suspension statutes found in applicable federal or state laws. *In re Baird*, 63 Bankr. 60, 63 (Bkrtcy.W.D.Ky. 1986). If no specialized suspension statute exists which tolls limitations during pendency of the automatic stay and an action would otherwise be barred by limitations, then bankruptcy law supplies a short filing period under § 108(c)(2). Under that provision, 30 days is established as the period of time during which suits which could not be filed while the stay was in effect may be filed without being barred by expiration of a state law limitations period that expired while the stay was in effect. The subparts of § 362 make clear that if a limitations period has not expired during the stay of actions, upon lifting of the stay the remainder of that state limitations period applies. However even if state limitations has run, the period for commencing such actions cannot expire less than 30 days from notice that the stay is lifted.

Here, the record discloses that the automatic stay was still in effect, at least as to Tully, as of March 15, 2006 – the day the adversary proceeding was filed. Therefore, at the time this adversary case was filed, Tully still had an assertable claim against Haughee under state law on the date Haughee filed his bankruptcy petition. By application of 11 U.S.C. § 108(c), Tully's complaint was timely as to the underlying debt asserted against Haughee. As a result, recovery in this adversary case in not barred pursuant to Indiana Code 34-11-2-3.[13]

[13] The real limitation issue is the timeliness of the adversary complaint under Fed.R.Bankr.P. 4007(c). Whatever affirmative defense or other basis for dismissal that

B. The Case on the Merits

Having now determined that this action is not barred by a statue of limitation, the court will now turn its attention to the merits of Tully's case. Tully asserts that there is a debt owed to her by Haughee arising from his "overbilling" to her of attorney's fees asserted by Haughee for services which he rendered to her. Tully also asserts that Haughee committed acts in relation to insurance proceeds payable as a result of her husband's death which give rise to an exception to discharge under either 11 U.S.C. § 523(a)(4) or (a)(6). Tully's contentions can be summarized as follows:

(1) The act of Haughee's not remitting to Tully the full amount of insurance proceeds which he received causes the amount Haughee withheld from those proceeds to apply against attorney's fee charges, to be a debt excepted from discharge under either 11 U.S.C. § 523(a)(4) or (a)(6). A corollary to this contention is that Haughee's not providing Tully with a statement of fees prior to the withholding somehow plays into a debt excepted from discharge under either 11 U.S.C. § 523(a)(4) or (a)(6).

(2) Haughee "overbilled" Tully for legal services rendered to her, which amount was withheld from proceeds remitted to Tully, thus causing the overbilled amount to be a debt excepted from discharge under either 11 U.S.C. § 523(a)(4) or (a)(6).

In an adversary proceeding to determine the nondischargeability of a debt, the burden of proof is on the plaintiff as to each element of the statutory exception to discharge. *In re Kreps*, 700 F.2d 372, 376 (7th Cir. 1983); *Zygulski v. Daugherty*, 236 B.R. 646, 653 (N.D. Ind. 1999), citing, *Matter of Scarlata*, 979 F.2d 521, 524 (7th Cir. 1992). Furthermore, exceptions to discharge are to be construed strictly against the creditor and liberally in favor of the debtor. *Matter of Scarlata*, 979 F.2d at 524 (citing, *In re Zarzynski,* 771 F.2d 304, 306 (7th Cir. 1985)).

Haughee may have had under this rule has been waived due to his failure to assert that ground in his pleadings in this case; *In re Kontrick*, 295 F.3d 724 (7th Cir. 2002).

The statute is to be narrowly construed so as not to undermine the Bankruptcy Code's purpose of giving the honest but unfortunate debtor a fresh start. *Park National Bank & Trust of Chicago v. Paul*, 266 B.R. 686, 293 (Bankr. N.D. Ill. 2001). The United States Supreme Court has held that the standard of proof in non-dischargeability proceedings under § 523(a) is a preponderance of evidence standard rather than the more stringent standard of clear and convincing evidence; *Grogan v. Garner*, 498 U.S. 279 (1991).

Lets's first turn to the legal requisites for sustaining an action under 11 U.S.C. § 523(a)(4), which provides that a debt is excepted from discharge if the debt is "for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny." For the purpose of determining dischargeability, embezzlement and larceny are defined by federal common law. *Valentine v. Valentine*, 104 B.R. 67, 70 (Bankr. S.D.Ind. 1988). In the Seventh Circuit Court of Appeals, larceny is proven under § 523(a)(4) if it is shown that the debtor wrongfully and with fraudulent intent took property from its owner; *In the Matter of Rose*, 934 F.2d 901, 902 (7th Cir. 1991) [citing, *In re Nahabedian*, 87 B.R. 214, 215 (S.D. Fla. 1998); *In re Hoffman*, 70 B.R. 155, 161 (W.D. Ar. 1986)]. Bankruptcy courts have taken the position larceny requires that felonious intent exist at the time of the taking; *In re Brown*, 2009 WL 2461241, *6 (Bankr. N.D. Ill. 2009) [citing, Black's Law Dictionary (6th ed. 1990)]; *United States life Title ins. Co. V. Dohm*, 19 B.R. 134 (N.D. Ill. 1982); *In re Hoffman*, 70 B.R. 155, 161 (Bankr. W.D. Ark. 1986) [citing, 3 *Collier on Bankruptcy*, ¶ 523.14[3] (15th ed. 1981)]. Thus, to constitute larceny, the debtor's original taking of possession of, or exercise of control over, property must be unlawful; *Dobek v. Dobek*, 278 B.R. 496, 509-10 (Bankr. N.D. Ill. 2002) [citing, *Pierce v. Pyritz*, 200 B.R. 203, 205 (Bankr. N.D. Ill. 1996)].

Embezzlement differs from larceny in that in embezzlement the original possession of, or exercise of control over, property is lawful – i.e. the property came into the hands of the debtor lawfully, as by consent – and then the owner's interests are unlawfully compromised; *In*

re Rose, 934 F.2d 901, 903 (7th Cir. 1991). The elements of "embezzlement" under 11 U.S.C. § 523(a)(4) have been well-defined by the United States Court of Appeals in *In re Weber*, 892 F.2d 534, 538-9 (7th Cir. 1989) as follows:

> Section 523(a)(4) of the bankruptcy code does not allow a debtor to discharge a debt incurred as a result of the debtor's embezzlement. Bankruptcy courts define embezzlement as the "fraudulent appropriation of property by a person to whom such property has been entrusted or into whose hands it has lawfully come." *Moore v. United States*, 160 U.S. 268, 269, 16 S.Ct. 294, 295, 40 L.Ed. 422 (1895), *quoted in In re Bevilacqua,* 53 B.R. 331, 333 (Bankr.S.D.N.Y.1985), *In re Myers,* 52 B.R. 901, 905 (Bankr.E.D.Va.1985), *In re Graziano,* 35 B.R. 589, 594 (Bankr.E.D.N.Y.1983); *see also In re Belfry,* 862 F.2d 661, 662 (8th Cir.1988). To prove embezzlement, the creditor must show by clear and convincing evidence that (1) the debtor appropriated funds for his or her own benefit; and (2) the debtor did so with fraudulent intent or deceit. *In re Taylor,* 58 B.R. 849, 855 (Bankr.E.D.Va.1986); *In re James,* 42 B.R. 265, 267 (Bankr.W.D.Ky.1984); *In re Storms,* 28 B.R. 761, 765 (Bankr.E.D.N.C.1983); *Graziano,* 35 B.R. at 595.
>
> Ablan initially argues that the bankruptcy court should have applied the embezzlement and conversion laws of Wisconsin. Although he cites no authority for this proposition, and admits that ultimately the issue of nondischargeability is a question of federal law, he claims that state law is "useful" in defining the elements of embezzlement. Ablan claims that the Wisconsin cases he cites "do not in any event conflict with the [federal standards]"; his analysis of this caselaw, however, leads him to conclude that "[t]he act of depositing [another's] funds into one's account, thereafter causing them . . to be dispersed for one's own purposes or uses is the kind of evidence which *would compel the conclusion that embezzlement has occurred.*" (emphasis added). Under federal law, such a conclusion is not compelled since the creditor must also prove that the dispersal occurred with fraudulent intent. Thus, Ablan had to prove more than just the fact that Weber used the sales proceeds to pay off his personal debts; he had to prove that Weber did so with fraudulent intent.

Additionally, the element of fraudulent intent is a constant in federal decisions under § 523(a)(4)'s "embezzlement" and "larceny" prongs; See, e.g., *In re Dempster*, 182 B.R. 790, 802 (Bankr. N.D. Ill. 1995); *In re Fields*, 2005 WL 2205787 (Bankr. C.D. Ill. 2005); *In re Brady*, 101 F.3d 1165, 1172-3 (6th Cir. 1996); *In re Rogstad,* 126 F.3d 1224, 1228 (9th Cir. 1997); *In re*

Fuget, 339 B.R. 702, 707 (Bankr. S.D. Iowa 2006); *In re Lammers*, 2005 WL 1498336 (Bankr. M.D. Fla. 2005).

In order to sustain an action for "embezzlement"or "larceny" under 11 U.S.C. § 523(a)(4), Tully must first establish that the debtor exercised unauthorized control over property. Next, she must demonstrate fraudulent intent on the part of the debtor, which entails establishing the use to which the misappropriated property was placed and the intent of the one misappropriating in doing the act of misappropriation. Therefore, although a debtor commits an act “knowingly” which may tend to support either larceny or embezzlement under § 523(a)(4), it is also necessary for a court to examine whether the facts of the case indicated fraud. Take for instance the case of, *In the Matter of Rose*, 934 F.2d 901, 902 (7th Cir. 1991):

> Plaintiff Elliott Kaye initiated an adversary proceeding in bankruptcy court against debtor Dawn Rose, who is his former wife, and her interim bankruptcy trustee, Allan J. Demars, to determine the dischargeability of a debt. Kaye's second amended complaint alleged that Kaye and Rose traveled to Australia in November 1982, when they were still married, bringing with them $184,000 in cash and traveler's checks belonging to Kaye. The couple deposited the sum in a safety deposit box to which both Rose and Kaye were signatories. Rose left Australia abruptly two months after their arrival, and Kaye alleged that Rose had taken $93,000 of his funds with her. She had mailed $80,000 to herself via a then friend in California and took the rest with her. In December 1982 Rose instituted divorce proceedings in the Circuit Court of Cook County, Illinois, where Judge Willard J. Lassers entered judgment in favor of Kaye and against Rose for $93,000 because of her "larcenous removal of said funds from Australia." Instead of returning Kaye's funds as ordered, Rose filed for bankruptcy. Kaye sought a determination from the bankruptcy court that the $93,000 debt was nondischargeable pursuant to 11 U.S.C. § 523(a)(4) because it had been incurred through larceny. Bankruptcy Judge Katz entered judgment after a two-day trial denying Rose a discharge from the $93,000 debt. The case was appealed to District Judge Ann C. Williams, who agreed with the bankruptcy court, and subsequently Rose appealed to the [Seventh Circuit Court of Appeals].

The appellate court upheld both the decisions of the bankruptcy and district courts, and as to the issue of fraudulent intent the court stated:

> Rose also cites *Rauch* for the proposition that any inference of fraud must be unequivocal. *Rauch*, 18 Bankr. at 99. In this case, the bankruptcy judge inferred from Rose's furtive mailings to California and from her knowledge that Kaye had no intention of sharing his funds with her that Rose had acted with fraudulent intent. **Intent may properly be inferred from the totality of the circumstances and the conduct of the person accused.** *Nahabedian*, 87 Bankr. at 216. *Rauch* is simply a case in which plaintiff failed to introduce any evidence from which an inference of fraud could be drawn.

Id. at 904. (Emphasis added)

A debt is also excepted from discharge under this provision when it arises as a result of the debtor committing fraud or defalcation while acting in a fiduciary capacity. However, not all persons treated as fiduciaries under state law are considered to "act in a fiduciary capacity" for purposed of federal bankruptcy law. *Follett Higher Education Group, Inc. v. Berman*, 629 F.3d 761, 767 (7th Cir. 2011). Rather the existence of a fiduciary relationship under § 523(a)(4) is a matter of federal law. *Id.* In the case of *Weichman v. Lazzaro, et al.*, 422 B.R. 143, 151-52 (Bankr. N.D. Ind. 2010), this court extensively summarized the concept of "fiduciary capacity" under this provision:

> In *In re Tsikouris*, 340 B.R. 604 (Bankr. N.D.Ind. 2006), this court addressed its analysis of the concept of "fiduciary capacity" under 11 U.S.C. § 523(a)(4). In doing so, the court sought to reconcile the somewhat conflicting decisions of the United States Court of Appeals for the Seventh Circuit with respect to this concept. Certain forms of a "fiduciary capacity" have been relatively well-defined by the case of *In the Matter of Marchiando*, 13 F.3d 1111 (7th Cir. 1994). This court commented on *Marchiando*'s analysis as follows:
>
> The teaching of *Marchiando* is not only that a statutory or contractual designation of an individual as a "trustee" or "fiduciary" has no real relevance to the determination of "fiduciary capacity" under § 523(a)(4). The primary lesson to be learned from the case is that there must be a "res" in existence *before* the designated "fiduciary" relationship truly arises. In this case, the only "res" there is arose only when Tsikouris did not make payments to the union benefit plans *after* the amount of the required payment was determined. Thus, because there was no "res" prior to that time, Tsikouris did not act in a "fiduciary capacity" in any manner with respect to the "debt" which the

Plaintiffs seek to except from his discharge. 340 B.R. at 614.

The most problematic Seventh Circuit case with respect to a relationship which constitutes a "fiduciary" relationship is *In re Frain,* 230 F.3d 1014 (7th Cir. 2000). This court addressed *Frain,* and synopsized its concept of a "fiduciary capacity" as follows:
In this Court's view, *Frain* is based upon the premise that a "fiduciary" relationship existed between Frain and his two fellow shareholders – much as would be the case in the relationship among a managing partner and limited partners in a partnership – and that this relationship rose to the level of the "fiduciary capacity" required by 11 U.S.C. § 523(a)(4) *because* of the structuring of the relationship in a way which provided Frain with total control over the focus of the fiduciary relationship: existing assets of the corporation, and the manner in which the corporation would disburse monies on its obligations. Contrast that to the instant case. Under the principles of *Marchiando,* no possible "fiduciary" relationship arose in this case until Tsikouris failed to pay the "employer's component" obligations to the union benefit plans: the Plaintiffs had no interest of any kind in the proceeds or assets of Tsikouris' business until the debt asserted in this case arose, and when it did, their interest was merely a debt, as was true in *Marchiando.* Additionally, the "ascendancy of power/position" critical to the analysis in *Frain* does not exist at all here. The union benefit plans are associated with the union, and due to that association are far more powerful than is a small sole proprietorship which employs union members in its business. Unions have the ability to totally immobilize an employer who does not fulfill the terms of a collective bargaining agreement, and for the Plaintiffs in this case to suggest that Tsikouris was in a position of ascendant power over a trade union and its associated employee benefit plans borders on the preposterous.

As the foregoing cases establish, a critical component of a fiduciary relationship within the scope of 11 U.S.C. § 523(a)(4) is a *res* which exists as the focus of the relationship, much as would be the circumstance in the case of an express trust created to manage property deposited into the trust at the inception of the fiduciary relationship; *See, Klingman v. Levinson,* 831 F.2d 1292, 1295 (7th Cir.1987). A mere promise to pay a debt when circumstances giving rise to the obligation to pay come into existence, made by an individual to another person or entity of equal or superior standing, is not within the ambit of 11 U.S.C. § 523(a)(4); *In re Woldman,* 92 F.3d 546 (7th Cir.1996). Even if a statute or ordinance labels a relationship to be a “fiduciary” relationship, that label has no consequence under § 523(a)(4) unless there is an existing *res* which is mandated by law to be the subject of the labeled relationship; *In re McGee,* 353 F.3d 537 (7th Cir.2003) [holding that a municipal ordinance which required the

> deposit of security deposits paid by tenants to a landlord into a segregated account, created a “fiduciary” relationship under 11 U.S.C. § 523(a)(4), in specifically delineated contrast to the circumstances outlined above in *Marchiando, supra.]*

The Seventh Circuit in the case of, *Meyer, et al. v. Rigdon*, 36 F.3d 1375, 1383-85 (7th Cir. 1994) stated the standard to determine “defalcation” under § 523(a)(4):

> The leading case defining "defalcation" is *Central Hanover Bank & Trust Co. v. Herbst.* In that case, Judge Learned Hand noted that "colloquially perhaps the word, 'defalcation,' ordinarily implies some moral dereliction, but in this context it may have included innocent defaults, so as to include all fiduciaries who for any reason were short in their accounts. . . . Whatever was the original meaning of 'defalcation,' it must here have covered other defaults than deliberate malversations, else it added nothing to the words, 'fraud or embezzlement." *Id.* at 511. The court went on to state, however, that "we do not hold that no possible deficiency in a fiduciary's accounts is dischargeable; in *[In] re Bernard,* 87 F.2d 705, 707 [(2nd Cir. 1937)], we said that 'the misappropriation must be due to a known breach of duty, and not to mere negligence or mistake.' Although that word [misappropriation] probably carries a larger implication of misconduct than 'defalcation,' 'defalcation' may demand some portion of misconduct; we will assume arguendo that it does." *Id.* at 512.
>
> In interpreting *Herbst,* courts have split over the question of whether mere negligent acts may be "defalcations." In *In re Johnson,* 691 F.2d 249 (6th Cir. 1982), the court adopted an "objective standard for finding a defalcation." *Id.* at 255. Under this standard, the bankruptcy petitioner is charged with knowledge of the law and his intent or motive is irrelevant in determining whether a debt is dischargeable. According to the court, "creating a debt by breaching a fiduciary duty is a sufficiently bad act to invoke the section 17(a)(4) exception even without a subjective mental state evidencing intent to breach a known fiduciary duty or bad faith in doing so." *Id.* at 256. Nonetheless, the court held that "mere negligence or a mistake of fact" is insufficient to constitute a "defalcation." *Id.* at 257.
>
> In *Carey Lumber Co. v. Bell,* 615 F.2d 370 (5th Cir. 1980), the Fifth Circuit interpreted the term "misappropriation" as it was used in section 17(a)(4), the predecessor of section 523(a)(4). In that case, the bankruptcy petitioner argued that in order for a debt to be excepted from discharge under section 17(a)(4), it would have to be shown that he "intentionally diverted, stole, or misappropriated funds . . . ." *Id.* at 375. The petitioner relied on language in *In re Bernard,* 87 F.2d 705 (2d Cir. 1937), "to the

effect that misappropriation under section 17(a)(4) 'must be due to a known breach of the duty, and not to mere negligence or mistake.'" *Carey Lumber Co.,* 615 F.2d at 375-376 (quoting *Bernard,* 87 F.2d at 707). The court initially held that, despite the language in *In re Bernard* that a misappropriation "must be due to a known breach of the duty," the petitioner is "charged with knowledge of his legal duties." *Id.* at 376. The court also went on to address the issue of whether a misappropriation may occur through negligent conduct:

Moreover, there is doubt as to the continued validity of the dicta in *In re Bernard* that misappropriation under section 17(a)(4) may not be found on the basis of "mere negligence or mistake." In *In re Hammond,* [98 F.2d 703 (2d Cir. 1938), *cert. denied,* 305 U.S. 646, 59 S. Ct. 149, 83 L. Ed. 418 (1939)] supra, a debt incurred by a bankrupt corporate director who had unlawfully taken advantage of a corporate opportunity that the corporation had been financially unable to take advantage of was held nondischargeable in bankruptcy under section 17(a)(4), despite a complete absence of evidence that the director's wrongdoing had been intentional. More recently, in *Matter of Kawczynski,* supra, the court wrote that "'defalcation' has been interpreted by the Second Circuit to include innocent defaults." 442 F. Supp. at 418. Thus there is no requirement that a misappropriation must be shown to have been intentional in order to be covered by section 17(a)(4). *Id.*

The Fifth Circuit more recently defined the term "defalcation" within the meaning of section 523(a)(4) as "a willful neglect of duty, even if not accompanied by a fraud or embezzlement." *In re Moreno,* 892 F.2d 417, 421 (5th Cir. 1990) (citing L. King, 3 *Collier on Bankruptcy* P 523.14 at 523-93 to 523-95 (15th ed. 1988)); *see also In re Bennett,* 989 F.2d 779 (5th Cir.), *cert. denied,* 126 L. Ed. 2d 566, 114 S. Ct. 601 (1993); *Matter of Davis,* 3 F.3d 113, 115 (5th Cir. 1993) (citing, *inter alia, Carey Lumber,* 615 F.2d at 375-376) ("Defalcation includes willful neglects of duty unaccompanied by fraud or embezzlement.").

By using the word "willful," the Fifth Circuit has put into question the validity of the *Carey Lumber* dicta concerning the issue of whether a negligent act may be a "defalcation." Black's Law Dictionary 1599 (6th ed. 1990) defines "willful" as "proceeding from a conscious motion of the will; voluntary; knowingly; deliberate. Intending the result which actually comes to pass; designed; intentional; purposeful; not accidental or involuntary." According to Black's, "[a] willful act differs essentially from a negligent act. The one is positive and the other negative." *Id.*

A bankruptcy court in the Fifth Circuit recently tried to reconcile

> *Matter of Moreno* and *Carey Lumber. See In re Gaubert,* 149 Bankr. 819 (Bankr. E.D. Tex. 1992). The *Gaubert* court rejected an argument made by the FDIC, based on *In re Chavez,* 140 Bankr. 413 (Bankr. W.D. Tex. 1992), that a mere breach of fiduciary duty meets the requirement for establishing a "defalcation." The court reconciled *Moreno* and *Carey Lumber* in the following manner:
>
> As a mere breach of fiduciary duty is negligent, the *Moreno* court's use of the term "willful" takes mere breaches of duty out of the defalcation category. On the other side, the *Carey Lumber* decision demonstrates that a standard that is less than intent is appropriate. It is consistent with the term willful and the purposes of the Bankruptcy Code to impose a standard of recklessness. Gaubert, 149 Bankr. at 827.
>
> ***
>
> Nonetheless, we agree with the Sixth Circuit (and possibly the Fifth) that mere negligent breach of a fiduciary duty is *not* a "defalcation" under section 523(a)(11). "It is a well recognized principle in bankruptcy law that exceptions to discharge are strictly construed against the objecting creditor and in favor of the debtor. This is based on the strong policy of the Bankruptcy Code of providing a debtor with a 'fresh start.'" *In re Marvin,* 139 Bankr. 202, 205 (Bankr. W.D. Wis. 1992) (citing *Gleason v. Thaw,* 236 U.S. 558, 35 S. Ct. 287, 59 L. Ed. 717 (1915)). Given this well-recognized principle, and the split of authority concerning whether a "defalcation" may result from negligence, we cannot say that Congress intended for a debt arising from a mere negligent breach of fiduciary duty to be excepted from discharge under section 523(a)(11).

The Seventh Circuit further delineated this concept in a footnote in the case of *In re Berman*, 629 F.3d 761, 766 (7th Cir. 2011):

> Black's Law Dictionary defines "defalcation" as a "failure to meet an obligation" or "a non-fraudulent default." *Black's Law Dictionary* 479 (9th ed. 2009). Defalcation can be distinguished from fraud and embezzlement on the basis that subjective, deliberate wrongdoing is not required to establish defalcation, though some degree of fault is required. See *Central Hanover Bank & Trust Co. v. Herbst*, 93 F.2d 510, 512 (2d Cir. 1937) (L. Hand, J.) (a fiduciary who takes money upon a conditional authority that may be revoked, and who knows that the authority may be revoked, is guilty of a "defalcation" even if the wrong falls short of fraud or embezzlement). We have held that defalcation requires something more than negligence or mistake, but less than fraud. See *Meyer v. Rigdon*, 36 F.3d 1375, 1385 (7th Cir. 1994).

Courts have held that under this standard defalcation includes the misappropriation of trust funds held in a fiduciary capacity and the failure to properly account for such funds. *Bruno v. Schlenk*, 2003 WL 21018591, *6 (Bankr. N.D. Ill. 2003) (citing, *Strube Celery & Vegetable Co., Inc. v. Zois (in re Zois)*, 201 B.R. 501, 506 (Bankr. N.D. Ill. 1996)). An objective standard is used to determine a defalcation – intent or bad faith is not required. *In re Pawlinski*, 170 B.R. 380, 389 (Bankr. N.D. Ill. 1994).

Let's next turn to the legal requisites applicable to sustain an action under 11 U.S.C. § 523(a)(6). In the case of *In re Whiters*, 337 B.R. 326 (Bank. N.D. Ind. 2006), this court stated the standards which it will apply to determine whether a debt is deemed nondischargeable pursuant to 11 U.S.C. § 523(a)(6). Those standards were subsequently summarized in the case of *In re Weichman,* 422 B.R. 143, 152-53 (Bankr. N.D. Ind. 2010) as follows:

> [I]n *In re Whiters,* 337 B.R. 326 (Bankr. N.D.Ind. 2006), the court stated its construction of the elements of an action under 11 U.S.C. § 523(a)(6). As stated in *Whiters,* determination of cases under § 523(a)(6) has been made extraordinarily complicated by the decision of the United States Supreme Court in *Kawaauhau v. Geiger,* 523 U.S. 57, 118 S.Ct. 974, 140 L. Ed. 2d 90 (1998). In *Whiters,* the court stated the following as to the basic elements of an action under § 523(a)(6) following the decision in *Geiger:*
>
> > Putting the foregoing together, the Court determines that in order to sustain an action under 11 U.S.C. § 523(a)(6) a creditor must demonstrate the following:
> >
> > 1. That the debtor's actions caused an "injury" to the person or property interest of the creditor
> >
> > 2. That the debtor's actions which caused the injury were the result of "willful" conduct by the debtor by which the debtor intended to effect an injury to the person or property interest of the creditor.
> >
> > 3. That the debtor's "willful" acts were undertaken in a "malicious" manner.
>
> Viewed as outlined above, the *Geiger* standard is extremely strict for creditors to meet. That is as it should be. Exceptions to discharge are supposed to hook "bad actors", not those who

merely act poorly. When we troll the murky depths of dischargeability from our place on the shore immediately above the dam, our goal is to snare the lampreys in the stream, not the carp and the catfish. Moreover, in the context of 11 U.S.C. § 523(a)(6), as is true with any exception to discharge, the creditor must prove each element of the dischargeability action by a preponderance of the evidence – *Grogan v. Garner,* 498 U.S. 279, 291, 111 S.Ct. 654, 661, 112 L.Ed.2d 755 (1991); *In re Bero,* 110 F.3d 462, 465 (7th Cir.1997), and "exceptions to discharge are to be construed strictly against a creditor and in favor of the debtor." *In re Scarlata,* 979 F.2d 521, 524 (7th Cir.1992), *reh. en banc denied* 1993; *In re Zarzynski,* 771 F.2d 304, 306 (7th Cir.1985). 337 B.R. at 339.

This court further adopted a "subjective" standard with respect to the willfulness element of § 523(a)(6), stating:

As the emphasized portion of the above-quoted section establishes, reference to the Restatement Second of Torts does not negate a totally "subjective" standard: in order to constitute "willful" conduct, a debtor must either "desire the consequences of his act" [target harm to another entity's person or property], or himself/herself *believe* that harm is substantially certain to result from his/her actions. After *Geiger,* there is no room for the "objective" inquiry into the probabilities of harm, because to do so renders the "willful" element of § 523(a)(6) tantamount to the mere intention to act without intending the consequences of the act in relation to the injury. *Geiger* requires "you *knew* that would hurt", not "any idiot would/should have known that would hurt". 337 B.R. 326, 343.

Finally, the court defined "malicious" under the statute as follows:

Malicious means " 'in *conscious* disregard of one's duties or without just cause or excuse; it does not require ill will or a specific intent to do harm.' " *In re Thirtyacre,* 36 F.3d 697, 700 (7th Cir.1994) (quoting *Wheeler v. Laudani,* 783 F.2d 610, 615 (6th Cir.1986)) (emphasis added). Consequently, a debtor's actions are not automatically labeled malicious simply because they are wrongful. *In re Posta,* 866 F.2d 364, 367 (10th Cir.1989). There must also be a consciousness of wrongdoing. *In re Stanley,* 66 F.3d 664, 668 (4th Cir.1995). It is this knowledge of wrongdoing, not the wrongfulness of the debtor's actions, that is the key to malicious under § 523(a)(6). *Posta,* 866 F.2d at 367; *In re Cardillo,* 39 B.R. 548, 550 (Bankr. D.Mass.1984). Without it there can be no "conscious disregard of one's duties," *Thirtyacre,* 36 F.3d at 700, only an unconscious one. *Accord, In re Grier,* 124 B.R. 229, 233 (Bankr.W.D.Tex.1991) ("Simply because the sale was in violation of the security agreement and was in fact an

intentional sale on the part of the debtor should not be enough to trigger a finding of malice."). *See also, Davis,* 293 U.S. at 328, 332, 55 S.Ct. at 153 (a willful and malicious injury does not automatically result from every tortious conversion).

In *Whiters*, the court addressed the nature of the injury subject to §523(a)(6):

> The key to applying *Geiger* . . . is to accurately identify the creditor's true injury. It is easy to confuse the unique damage caused by the debtor's action with the creditor's true injury and it is that confusion that leads to the construction of causal chains linking action with injury. Nonetheless, the true injury is not the unique or case specific damages that are somehow monetized and then memorialized in a money judgement. Those damages are only the manifestation of the true injury. They indicate the magnitude of the creditor's injury, not whether an injury has occurred. Admittedly, the magnitude of the injury will influence whether a creditor is interested in pursuing the matter and what, if anything, it may recover should it do so. Nonetheless, the lack of damage does not necessarily mean that no injury has occurred, it means only that no real harm has come of it. Indeed, it is the recognition that there can be injury without harm that lies behind the opportunity to recover nominal damages.
>
> **The creditor's true injury occurs on an abstract level. It is the debtor's invasion of the creditor's legally protected right. The court should focus on this injury, as opposed to the resulting damage, when it asks whether the injury was intentional. When it does so, the answer will usually be relatively obvious because the debtor's action *is* the injury.** For example, in a case involving assault and battery, the true injury is not the creditor's broken jaw, but rather, the unconsented to touching that produced the broken jaw. Consequently, the question to ask is not whether the debtor intended to break the creditor's jaw, but instead, whether the debtor intended to hit the creditor. In defamation cases, the true injury is not the damage to the creditor's reputation; it is the publication of falsehoods about the creditor that led to the damaged reputation. Consequently, the proper question is not whether the debtor intended to injure the creditor's reputation, but instead, whether the debtor intended to publish the defamatory remarks. **Similarly, in the conversion of collateral scenario, the true injury is not that the creditor's debt goes unpaid. The true injury is that the creditor's collateral was wrongly or improperly disposed of and that the proceeds were used for purposes other than payment of the obligation that property secured. *See, In re LaGrone,* 230 B.R. 900, 904 (Bankr. S.D.Ga.1999). Consequently, the proper question is not whether the debtor intended that its secured**

> **creditor would go unpaid. Instead, the question to ask is whether the debtor intended to improperly use the creditor's collateral and/or its proceeds for purposes other than the payment of the debt that property secured. If so, there is an intentional injury.**
>
> Just because the debtor may have intentionally injured the creditor is not enough to make the resulting debt nondischargeable. Section 523(a)(6) has two components. The injury must not only be willful (intentional); it must also be malicious. This requirement is separate and distinct from the issue of willfulness. *See, Kimzey,* 761 F.2d at 424; *Markowitz,* 190 F.3d at 463; *In re Scarborough,* 171 F.3d 638, 641 (8th Cir.1999), *cert. denied,* 528 U.S. 931, 120 S.Ct. 330, 145 L.Ed.2d 258 (1999). *But see, Miller,* 156 F.3d at 606 (*Geiger* established a unitary concept for willful and malicious).

In re Whiters, 337 B.R. at 348-49 (Emphasis added).

Therefore, when determining whether a debt is excepted from discharge under § 523(a)(6), the primary focus is not on the specific injury suffered by the creditor, but rather upon the personal interest or property interest which the debtor intended to affect by the debtor's conduct. In relation to that interest, it is the intent to cause an injury or to intentionally act in a manner which *the debtor knows* will cause injury, or *subjectively should have known* will cause injury, that is the core of the action.

In order for Tully to succeed, the court must find that there is a debt owed by Haughee to Tully, and that the debt is excepted from discharge under either § 523(a)(4) and § 523(a)(6). The parties stipulated that the amount in controversy, i.e. the potential debt, is the $8,775.75 Haughee withheld from the life insurance proceeds (which he used to offset his outstanding attorney fees).

In reaching a determination in this case, the court must take into consideration the credibility of the witnesses who testified. In determining the credibility of a witness, the court in the case of *In re Fosco*, 289 B.R. 78, 87 (Bankr. N.D. Ill. 2002) stated the following:

> It is well-settled that a court, when sitting without a jury, may take

> into account a witness' interest in the outcome of the case, his intentions, his seeming honesty . . . Welch v. Tennessee Valley Authority, 108 F.2d 95, 101 (6th Cir. 1939) . . . It is by no means necessary for me to rely solely on the words used by a witness when making up my mind about the truth of the matter the witness testifies to. Id. at 269. Within the bounds of reason, I am at liberty to reject the testimony of a witness that does not produce conviction in my mind about its truthfulness. Joseph v. Donover Co., 261 F.2d 812, 824 (9th Cir. 1958). On the other hand, of course, I am not at liberty to arbitrarily reject uncontroverted evidence. Id.

Only two witnesses testified in this case – Tully testified during her case in chief and she called Haughee as a witness. For the defendant, Haughee, proceeding *pro se,* provided the court with a narrative. The record testimony left the court with the determination that Tully's testimony was evasive and lacked credibility. On the other hand, Haughee's testimony was internally consistent and in consonance with the exhibits admitted into evidence.

The court will first address Tully's allegation that she did not authorize Haughee to administer the life insurance proceeds in the first place or to offset a portion of the life insurance proceeds against Haughee's outstanding attorney fees. Haughee testified that he discussed the scope of his representation with Tully on several occasions and that she did, in fact, authorize him to obtain the life insurance proceeds. Haughee also contends that Tully knew that he was going to use a portion of the insurance proceeds to offset his fees.

The best place to start is the Fee Agreement entered into between the parties.[14] The first paragraph of the agreement sets out the intended scope of Haughee's representation:

> IN THE LEGAL MATTER OF: Review And Analysis Of Assets Payable To Mary Ann Tully, Surviving Spouse; And Debts Owed From Deceased Husband's Death (emphasis supplied)

The foregoing statement is sufficient to encompass matters relating to the life insurance

[14] This document was entered into evidence as Defendants Exhibit #1. Also, at trial Tully admitted to entering into this agreement with Haughee. See, Trial Transcript at pg 17, lines 16-17.

proceeds. Paragraph one of the agreement states in pertinent part:

***

> Any and all additional work which the client requests Mr. Haughee to perform, although not precisely and/or exactly specified in this contract, shall be charged to the client at the rate of $110.00 per hour for legal fees incurred which are out of court and $150.00 per hour for legal fees which are incurred in Court and shall be paid by the client within 15 days of presentation of statements therefore.

***

Therefore, the Fee Agreement allows for work to be performed by Haughee to obtain the life insurance proceeds on behalf of Tully and to bill for that work. Was Haughee then authorized to retain a portion of the proceeds to offset his fees? For the reasons explained below, the court finds that Haughee was indeed authorized to both obtain the life insurance proceeds for Tully and to then offset his fees with a portion of the proceeds.

The date of October 28, 2003 is hand-written in the upper right hand corner of the Fee Agreement. This is apparently the date the contract was drafted, and the court concludes that this was when Tully and Haughee first discussed the terms of payment and the intended scope of Haughee's representation. The first page of this document is signed by Tully and dated; however this was a photocopy of the original and the date is illegible. At trial Haughee testified that the original agreement contained the hand-written date of November 7, 2003. Haughee submitted into evidence a letter he sent to Tully dated October 28, 2003, which states as follows:

> Dear Mary Ann:
>
> During today's conference you indicated that you are interested in paying the $3,000 legal retainer we discussed, and the remaining attorney fees and costs balance on a 1/3 contingency fee from the insurance settlement proceeds for the total recovery on the Metropolitan Life Insurance, – estimated by you to have a value exceeding $65,000.00 – and which you believe is payable to you. In addition, you stated that you will pay all other matters on an hourly basis. I realize that you are tired, frustrated and angry to have been unable to successfully conclude the Metropolitan Life

> Insurance matter after numerous attempts. However after considering your proposal, I believe that an hourly contract on all outstanding matters, including the Metropolitan Life Insurance problem, is the fairest compensation method under the circumstances of your case.
>
> Furthermore, since you are Mr. Tully's surviving spouse, opening an estate will not be necessary to obtain the non-testamentary assets and benefits you're entitled to under various contracts and by law. In fact, opening an insolvent estate under the current circumstances would be an unsuitable waste of your money and time; and unless future circumstances change, and the estate becomes solvent, I don't recommend opening an insolvent estate.
>
> Accordingly, the contract which we agreed to is to accept all matters on an hourly basis. Then, when the life insurance proceeds are received, our office will deduct the outstanding attorney fees and costs payable at that time from the settlement check' proceeds received and issue you our trust account check for the net balance payable to you.
>
> Thereafter for work completed after the insurance proceeds are received, you agree to pay any later additional balances due for work performed per the Fee Agreement.
>
> If you are agreeable to accepting the abovementioned terms and conditions, then please execute and date the Fee Agreement and return it to the office.
>
> If you have any questions please feel free to contact us. Thank you.[15]

The Fee Agreement was sent to Tully as an enclosure to this letter. According to Haughee, Tully proceeded to then execute and date the agreement as of November 7, 2003. This chronology of events was corroborated by Haughee's testimony at trial:

> The Court: Okay. Let me just do something. Let me ask you this: Mike [Haughee], your contention is the total amount that you received is the 8,000 – is it correct that the total amount you contend you received is $8,775.75 cents plus $2,000.00 retainer?
>
> Mr. Haughee: That is correct, and as she's agreed she paid a thousand at the time that she signed the contract that was drawn up October 28th, 2003, and if you look on the second page there

[15] See, Defendant's Exhibit #2.

she signed that on November 7th, but the date is cut off, and then she paid another thousand between November of 2003 and the time of the December 15th billing; as far as when that was paid, I'm not sure.[16]

***

The Court: Okay. And apart from Exhibit H was there any other agreement between you and Ms. Tully as to how your fees might be paid?

Mr. Haughee: Yeah, I think it's my Exhibit 2 that's been submitted to the Court, November, 7th 2003, a letter that confirmed the fact that when the money was received that we were authorized to receive the fee that was owed at that time; and that we never received any objection to that letter orally or in writing from Mary Ann. And I don't remember if there are any other exhibits. I don't have my exhibits in front of me. I do remember that letter and I also remember that exhibit – oh, wait, that might be Exhibit 3.

The Court: No, it actually is Exhibit 2 just so you're clear –

(The witness examined the exhibit.)

Mr. Haughee: No. I'm talking about –

The Court: That's your Defendant's Exhibit 2.

Mr. Haughee: Right, okay. This one is important and also Exhibit 3; I talked about that. Yeah, it's hard to have these numbers memorized. Exhibit 3, which I sent to her the day that she signed the contract, because we agreed on it October 28, 2003, but when she signed it if you look at the bottom of the second page the date is cut off. But she signed it November – it's the first page. You can see it like top of 11703, and I don't know if it's cut off, and I don't have the original contract so – but this letter was to confirm and as it says here per our written agreement.[17]

The court finds this version of events to be credible. Haughee also submitted into evidence a second letter he sent to Tully dated November 7, 2003, where he once again confirmed that his attorney fees and costs would be deducted from the life insurance

---

[16] See, Trial Transcript at pg. 25, lines14-24.

[17] See, Trial Transcript at pg. 54, lines 19-25 through pg 55, lines 1-20.

proceeds.[18] Tully did not refute the fact that these letters were sent or that she received them. Tully did not present the court with credible evidence that she objected to the work Haughee was going to do or how he was going to be paid.

Based upon the letters that were sent to Tully and the fee agreement, the court finds that Tully retained Haughee to obtain the life insurance proceeds on her behalf and that she knew he was going to deduct his fees from the total amount received prior to sending her the final check. Additionally, the Fee Agreement specifically gives Haughee a lien on the life insurance proceeds and allows him to offset his fees. The second page of the Fee Agreement, which contains additional terms and conditions [the bottom of this page is also signed by both Tully and Haughee (although is not dated)], provides in pertinent part:

> 4. That ATTORNEY shall have a possessory and equitable lien on all property of the CLIENT which is in ATTORNEY's possession and on any claim, judgment, verdict, monies or other property paid into court or paid to client as a compromise in settlement of any claim and/or any asset of value of which the CLIENT holds any ownership or beneficial interest for payment of ATTORNEY'S fees and expenses pursuant to this agreement.
>
> ***
>
> 13. CLIENT does hereby authorize and give ATTORNEY the right and power to make, draw, and endorse promissory notes, checks, or bills of exchange and to waive demand, presentment, protest, notice of protest, and notice of non-payment on all such instruments; to make and execute any and all contract; to receive and to demand all sums of money, debts, dues, accounts, bequests, interest, dividends, and demands whatsoever which are now or shall hereafter become due or payable to CLIENT and/or ATTORNEY and to compromise or discharge the same; to receive any and all confidential information; to perform any and all acts that the CLIENT can perform which directly or indirectly concern this legal matter, and to make and execute all contracts.[19]

Given the foregoing evidence, Tully's argument that she did not authorize Haughee to obtain the life insurance proceeds cannot be sustained. Her argument that Haughee was not

---

[18] See, Defendant's Exhibit #3.

[19] See, Defendant's Exhibit #1 at ¶s 4 & 13.

authorized to deduct his fees from these monies is also not sustainable given the record evidence. Based upon the foregoing, the Court finds that Haughee acted within the scope of his representation when he obtained the life insurance proceeds, and that he was authorized to use this money to offset his outstanding fees. Even absent this finding, and even if there were some doubt as to the parties' agreement in this regard, there is no evidence to sustain Tully's burden of proof that the acts of receiving the insurance proceeds and setting off compensation for Haughee's services were done maliciously or fraudulently, or with intent to harm Tully's interest in the insurance proceeds. Therefore, the court determines that the act of withholding $8,775.75 from the life insurance proceeds is not excepted from discharge under the larceny or embezzlement prongs of 11 U.S.C. § 523(a)(4), or under 11 U.S.C. § 523(a)(6).

Tully's final argument is that Haughee over-billed her for his legal services in the amount of $8,775.75, and that this "overbilled" amount should therefore be excepted from discharge. The issue is twofold: (1) Did Haughee over-bill Tully for his legal services; (2) If so, would this implicate the defalcation prong of § 523(a)(4), or 11 U.S.C § 523(a)(6)?

There is no dispute that the fiduciary relationship contemplated by § 523(a)(4) existed between the parties. Haughee, as Tully's attorney, took possession of her property and was subject to the Rules of Professional Conduct to safeguard that property. As discussed, defalcation in the Seventh Circuit is defined as something more than negligence or mistake, but less than fraud. The evidence shows that Haughee received a check from the life insurance company in the amount of $68,885.84. He then mailed Tully a billing statement dated December 15, 2003, after he had already offset his outstanding attorney fees from the life insurance proceeds. This billing statement was general in nature and did not provide a day to day/hour break-down of the services provided. Along with the billing statement, Haughee also enclosed a check drawn on his trust account payable to Tully in the amount of $60,090.09. This was the balance of the insurance payout that Tully received in the form of a check drawn

on Haughee's trust account, which she proceeded to endorse and cash.

At trial, Tully made much of the fact that Haughee did not provide Tully an opportunity to "object" to his fees prior to the offset occurring. This asserted ground is meaningless – it is an entirely customary practice for an attorney in possession of client funds, and who has an agreement with a client to do so (as the court has found is the case here), to deduct fees/expenses from those funds and to state the offset at the time the resulting moneys are sent to the client. There is no legal authority whatsoever for the proposition that the attorney must send a statement for the offset amount in advance.

Let's look next at the fees billed. Haughee submitted evidence that between October 28, 2003 and December 30, 2003, he and his support staff spent over 200 hours rendering legal services for Tully. Tully submitted a billing statement into evidence dated December 15, 2003 for services provided to her for the period October 28, 2003 through December 15, 2003.[20] This statement reflects an outstanding balance of $8,775.75. This amount was then paid *via* an offset of the life insurance proceeds Haughee received. In summary, this statement reflects $15,042.50 in attorney fees (136.75 hours at $110.00 per hour), legal assistant fees in the amount of $669.75 (28.5 hours at 23.50 per hour) plus $4,310.00 in discounts and a $2,000.00 credit for payments received, which is more likely than not the retainer paid to Haughee.

Tully also submitted into evidence a second billing statement she received from Haughee dated January 18, 2004.[21] This invoice was for services provided to her for the period of December 16, 2003 through January 18, 2004. This statement reflects a balance due in the

---

[20] See, Plaintiff's Exhibit I. Included in the final amount is a fee for copying and facsimile transmissions.

[21] See, Plaintiff's Exhibit K. Included in the final amount is a fee for copying and facsimile transmissions.

amount of $3,590.07: $4,345.50 in attorney fees (39.50 hours at $110.00 per hour), legal assistant fees in the amount of $152.75 (28.5 hours at 23.50 per hour), plus $1,100.00 in discounts. It was established at trial that this invoice went unpaid and Haughee decided not to pursue collection.

Tully is seeking to except from discharge the amount Haughee withheld from the life insurance proceeds – $8,775.75 – based upon the assertion that she was over-billed in the amount of $8,775.75.

The standards utilized by both state and federal courts in awarding attorney fees provide a starting point by which the overall reasonableness of attorney fees can be measured. Under Indiana law, when awarding attorney fees, it is largely within the trial court's discretion to determine what is reasonable. *Franklin College v. Turner*, 844 N.E.2d 99, 105 (Ind. Ct. App. 2006). When making this determination the court may consider factors such as the hourly rate that is charged, the result achieved, and the difficulty of the issues involved in the litigation. *Id.* The trial court, "is considered to be an expert on the question and may judicially know what constitutes a reasonable attorney's fee." *Rand v. City of Gary,* 834 N.E.2d 721, 723 (Ind. Ct. App. 2005).

Indiana courts and federal courts have adopted the "lodestar" determination in calculating a reasonable fee to award. As stated by the court in the case of, *Cooper v. Verifications, Inc.* 2008 W.L. 5332190, *11-*12 (N.D. Ind. 2008):

> The district court enjoys "wide latitude" in establishing attorney fee awards. *Divane v. Krull Elec. Co.,* 319 F.3d 307, 314 (7th Cir.2003); *Greenfield Mills, Inc. v. Carter,* 569 F.Supp.2d 737, 744 (N.D.Ind.2008). In *Hensley v. Eckerhart,* 461 U.S. 424, 437, 103 S.Ct. 1933, 76 L.Ed.2d 40 (1983), the Supreme Court stated that the most useful starting point for a court to determine the amount of a reasonable fee is the "number of hours reasonably expended on the litigation multiplied by a reasonable hourly rate" – the so-called "lodestar" determination. *Gisbrecht v. Barnhart,* 535 U.S. 789, 802, 122 S.Ct. 1817, 152 L.Ed.2d 996 (2002) (citing *Hensley,* 461 U.S. at 433); *see generally Hall,* 943 F.Supp. at

540-47 (applying the lodestar methodology in an FCRA case). The attorney fee award applicant bears the burden of establishing and documenting the appropriate hours expended and hourly rates. *Greenfield Mills,* 569 F.Supp.2d at 744 (citing *Hensley,* 461 U.S. at 437).

a. *The reasonableness of the hourly rate*

As to the reasonableness of the hourly rate, it is determined by reference to the marketplace. *Hensley,* 461 U.S. at 433; *Spegon,* 175 F.3d at 554-55; *Greenfield Mills,* 569 F.Supp.2d at 756. That is, "[a]n attorney's market rate is the rate that lawyers of similar ability and experience in the community normally charge their paying clients for the type of work in question." *Greenfield Mills,* 569 F.Supp.2d at 756 (quoting *Spegon,* 175 F.3d at 555); *see Hensley,* 461 U.S. at 433.

b. *The reasonableness of the hours*

As to the reasonableness of the hours expended, the Supreme Court has stated that counsel is expected to exercise "billing judgment" and thus when calculating the fee award, a court should exclude hours that were not "reasonably expended," including "excessive, redundant, or otherwise unnecessary" work. *Hensley,* 461 U.S. at 434 ("Hours that are not properly billed to one's *client* also are not properly billed to one's *adversary* pursuant to statutory authority (citation omitted)); *see also Spegon v. The Catholic Bishop of Chicago,* 175 F.3d 544, 550 (7th Cir.1999); *Greenfield Mills,* 569 F.Supp.2d at 746. For example, the court must disallow hours spent on tasks that would not normally be billed to a client and also those hours expended by counsel on tasks that are easily delegable to non-professional assistance. *Spegon,* 175 F.3d at 553; *Greenfield Mills,* 569 F.Supp.2d at 746.

(1) *Vagueness*

"Counsel are 'not required to record in great detail how each minute of [their] time was expended. But at least counsel should identify the general subject matter of [their] time expenditures.' " *Greenfield Mills,* 569 F.Supp.2d at 746 (quoting *Hensley,* 461 U.S. at 437 n. 12); *see, e.g., Habitat Educ. Ctr., Inc. v. Bosworth,* Nos. 03C1023, 03C1024, 04C0254, 2006 WL 839166, at *6 (E.D.Wis. Mar.29, 2006) (declining to award fees for billing entries that were vague in that they failed to identify the subject matter of the meeting, e-mail, or telephone call); *Harper v. City of Chicago Heights,* Nos. 87 C 5112, 88 C 9800, 1994 WL 710782, at *4 (N.D.Ill.Dec.16, 1994) (reducing lodestar where billing entries for telephone conferences were vague and failed to identify the

> subject matter of the call). That is, counsel "should maintain billing time records in a manner that will enable a reviewing court to identify distinct claims." *Hensley,* 461 U.S. at 437." Where a court finds hours to be insufficiently documented, it may disallow those hours or reduce the entire fee award by a proportionate amount. *Delgado v. Vill. of Rosemont,* No. 03 C 7050, 2006 WL 3147695, at *2 (N.D.Ill. Oct.31, 2006) (citing *Harper v. City of Chicago Heights,* 223 F.3d 593, 605 (7th Cir.2000)).

Courts have also held that billing entries with cryptic references such as "telephone call to X" or "strategy conference", or time records that lump together multiple tasks in a single block of billed time are vague because it is impossible to evaluate them and determine whether "appropriate billing judgment" was exercised. See, *Needham v. Innerpac, Inc.*, 2008 W.L. 5411638, *2 (N.D. Ind. 2008). One thing to keep in mind is that in the cases cited above, the burden of proof was on the attorney seeking the award to demonstrate that his or her charges were reasonable and properly billed. However, the case presently before the court is a dischargeability action, and the burden is on the plaintiff to prove her case by a preponderance of the evidence. This includes proving the existence of a debt. Therefore, it is up to Tully to prove that Haughee over-billed her for his services, or that he did not perform the work set out in the billing statements – and to then prove that the resulting debt owed by Haughee to Tully is excepted from discharge under either § 523(a)(4) or § 523(a)(6).

The evidence establishes that Haughee reviewed Tully's husband's medical bills, resulting in her not having any monetary obligation for them. Haughee investigated certain issues that Tully was having with her investment broker, and he helped her look for a car. During this proceeding, the only work Tully contends was not within the scope of Haughee's representation was the act of obtaining of the life insurance proceeds. She never argued that this other work was not within the scope of Haughee's representation. Her contention is that no tangible "legal result" resulted from Haughee's time. Tully completely disregards the concept that time spent as an attorney is time spent, whether it derives from sorting through a jumbled

box of documents, accompanying a client in tasks that perhaps aren't "legal" in nature but are requested by the client and are within the scope of a compensable attorney/client agreement, or even " hand holding" because a client seeks a lawyer's advice about "non-legal" decisions which the client confronts. Anyone who has represented clients in traumatic life circumstances – most pointedly divorce or probate arising from the death of a spouse – has spent compensable time dealing with clients in matters that have no immediate legal matter focus. Haughee submitted detailed time records into evidence, and the court finds that Tully failed to present evidence that sustained her burden of proof that those records did not justify billing her for $8,775.75 for Haughee's legal services performed in accordance with his arrangement with her for his services.

Therefore, the court determines that Tully did not sustain her burden of proof to prove that Haughee over-billed her for his services, and that there is a debt to her that could ultimately be excepted from discharge pursuant to either 11 U.S.C. § 523(a)(4) or 11 U.S.C. § 523(a)(6).

IT IS THEREFORE ORDERED, ADJUDGED AND DECREED that the plaintiff, Mary Ann Tully, has failed to establish that there is a debt owing to her by the defendant Michael Haughee excepted from discharge.

IT IS FURTHER ORDERED, ADJUDGED AND DECREED that the plaintiff, Mary Ann Tully, recover nothing by way of her complaint against the defendant, Michael Haughee.

Dated at Hammond, Indiana on March 26, 2012.

/s/ J. Philip Klingeberger
J. Philip Klingeberger, Judge
United States Bankruptcy Court

Distribution:
Attorney for Plaintiff
Defendant